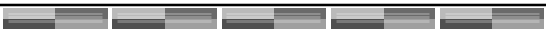


AICPA Statement on Auditing Standard No. 112 – *Communicating Internal Control Matters Identified in an Audit*

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What is the AICPA?


- National organization for CPAs
- Develops audit standards for CPAs
- APA must follow these standards
 - 45 KAR 1:050

Section 2. Auditing Standards, Procedures and Formats. The financial and compliance audit of the funds contained in each county's budget shall be conducted in accordance with:

(1) Auditing standards generally accepted in the United States of America, referenced in 201 KAR 1:300, Sec. 5(1)(a);

(2) Generally accepted government auditing standards, referenced in 201 KAR 1:300, Sec. 5(1)(b); and

(3) "Audit Guide for Fiscal Court Audits," issued by the Auditor of Public Accounts[, September 15, 2004].



What is SAS 112?

- New Auditing Standard issued in 2006
- Requires auditors to:
 - evaluate control deficiencies for significance
 - communicate in writing to management
 - significant deficiencies
 - material weaknesses

Why must the APA follow these standards?

- Receipt of federal grant funds requires an audit which meets national standards
- Audits must meet national standards to be valid when governments are looking to borrow money or sell bonds
- State law requires the APA to follow these standards
- Auditing standards provide protection and consistency to local officials and taxpayers that public funds are being properly expended

What are internal controls?

- The process used by management to provide reasonable assurance of :
 - reliable financial statements
 - effective and efficient operations
 - compliance with laws and regulations

How will SAS 112 affect you?

- More audit findings could be in the report
- Prior year exit conference and verbal comments may now be in the report
- We must report potential misstatements, not just known errors
- Large or numerous audit adjustments may result in audit findings
- The audit process may take longer

How is this different than current audit work?


- More time must be spent evaluating the internal control system
- Communication of significant deficiencies must be in writing
- Auditors have less discretion in determining whether or not to report a finding in writing

What can you do to prepare?

- Review prior year audits & exit conference documents
- Identify internal controls & areas of risk
- Find out how to improve the control environment in your office
 - Risk assessment – Where are your weaknesses?
 - Staff training
 - Document controls – Do you have written policies & procedures?


Issues that may be reported

- Employees or management lack qualifications for position
- Inadequate documentation
- Inadequate controls in place
- **Inadequate segregation of duties**
- Intentionally misleading the auditor
- Management override of controls




Issues that must be considered significant deficiency

- Ineffective antifraud programs & controls
- Ineffective controls over unusual and/or manual transactions
- Ineffective controls over month-end or year-end reporting



Issues that will be strong indicators of material weakness

- Management not having strong oversight of internal controls & financial reporting
- Restatement of prior financial statements for material misstatement
- Material misstatement identified by auditor not caught by internal controls
- Senior management fraud
- Management not correcting prior deficiencies
- Ineffective control environment



What is the APA doing to prepare?


- Educating state & local officials (auditees)
- Training our staff/Training private CPAs working for the APA
- Working to assure statewide consistency among auditors
- Most Common Exit Comments (Internal Controls)
- Attending local official training
- Coordinating with GOLD & various organizations representing local officials



Please note:


This auditing standard applies whether an audit is performed by the APA or a private CPA firm.

Bottom Line – You may be doing the exact same thing as last year but have more audit comments this year because of SAS 112.



Most Common Internal Control Findings

- Segregation of Duties – should endeavor to adequately segregate duties or have appropriate compensating controls in place
- Reconciliations - timely bank reconciliations should be prepared
- Deposit - intact deposits should be made daily
- Records - accurate accounting records, including receipts and disbursements journals should be maintained and reconciled



Most Common Internal Control Findings

- Expenditures – invoices should be paid timely, cancelled upon payment, and maintained as supporting documentation
- Timesheets – timesheets should be maintained and signed by employee and supervisor
- Receipts – receipts should be issued in triplicate
- Grant Funds – should properly monitor grant funds, including maintaining good records and supporting documentation

Most Common Internal Control Findings

- Capital Asset Records – maintain records and perform annual inventory count
- Other basic internal control weaknesses
 - Computer passwords and access should be restricted
 - Check signing restricted
 - Control over incoming checks should be increased

Internal Controls

See Handout for examples
of controls &
compensating controls

Additional Training

Association Meetings

- Internal Controls & Fraud

Contact the APA

- web page www.auditor.ky.gov
- phone 502-573-0050
- fax 502-573-0067
- email first.last@auditor.ky.gov

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INTERNAL CONTROLS

Environmental Controls

MANAGEMENT INVOLVEMENT

- Management should set the tone by supporting the importance of internal controls.
- Employees should be educated on the purpose and importance of internal controls.
- Design and maintain an adequate system of internal controls.

ORGANIZATIONAL STRUCTURE

- Identify specific assignment of duties and responsibilities by employee title and/or classification.
- Communicate and document who can authorize transactions.

PERSONNEL POLICIES AND PRACTICES

- Hire qualified and honest employees for sensitive positions.
- Perform background checks and reference checks for all positions handling cash and receipts.
- Require employees who handle cash to be bonded **(KRS 75.170)**.
- Require employees to take annual vacations.

MONITORING

- Be alert to “red flags” that could indicate potential problems.
- Actively monitor and investigate discrepancies (errors or irregularities).

Management Controls

AUTHORIZATION OF TRANSACTIONS

- Written authorization to initiate transactions is obtained in advance.

SEGREGATE INCOMPATIBLE DUTIES

- No employee should be in a position to commit an irregularity or fraud and then conceal it. In other words, no individual is able to authorize a transaction, record the transaction in the accounts, and have custody of the asset.
- If segregation of duties are not possible (due to staffing levels), compensating controls should be put in place.

DOCUMENTATION

- Key documents should be sequentially numbered.
- Spoiled documents should be voided and retained.
- Implement the use of duplicate documents (from vendors or computer generated)
- Computer policies and procedures should be documented.

ACCESS CONTROLS

- Physical security should be maintained over assets and records at all times.
- Access to computers should be restricted both physically and with the use of passwords.

Management Controls (Continued)

RECONCILIATION OF UNDERLYING DATA

- The cash balance reported in the bank statement should routinely be reconciled with the cash balance recorded in the accounts. (i.e. General Fund, Debt Service Fund, and Capital Projects Fund.)
- Fixed assets and supplies should be inventoried annually.
- Receivables should be confirmed periodically.

FOLLOW-UP ON INDICATIONS OF POTENTIAL ERRORS OR IRREGULARITIES

- Management should be alert to “red flags” and take timely and effective corrective action on all indications of errors and irregularities.

ACCOUNTING MANUAL

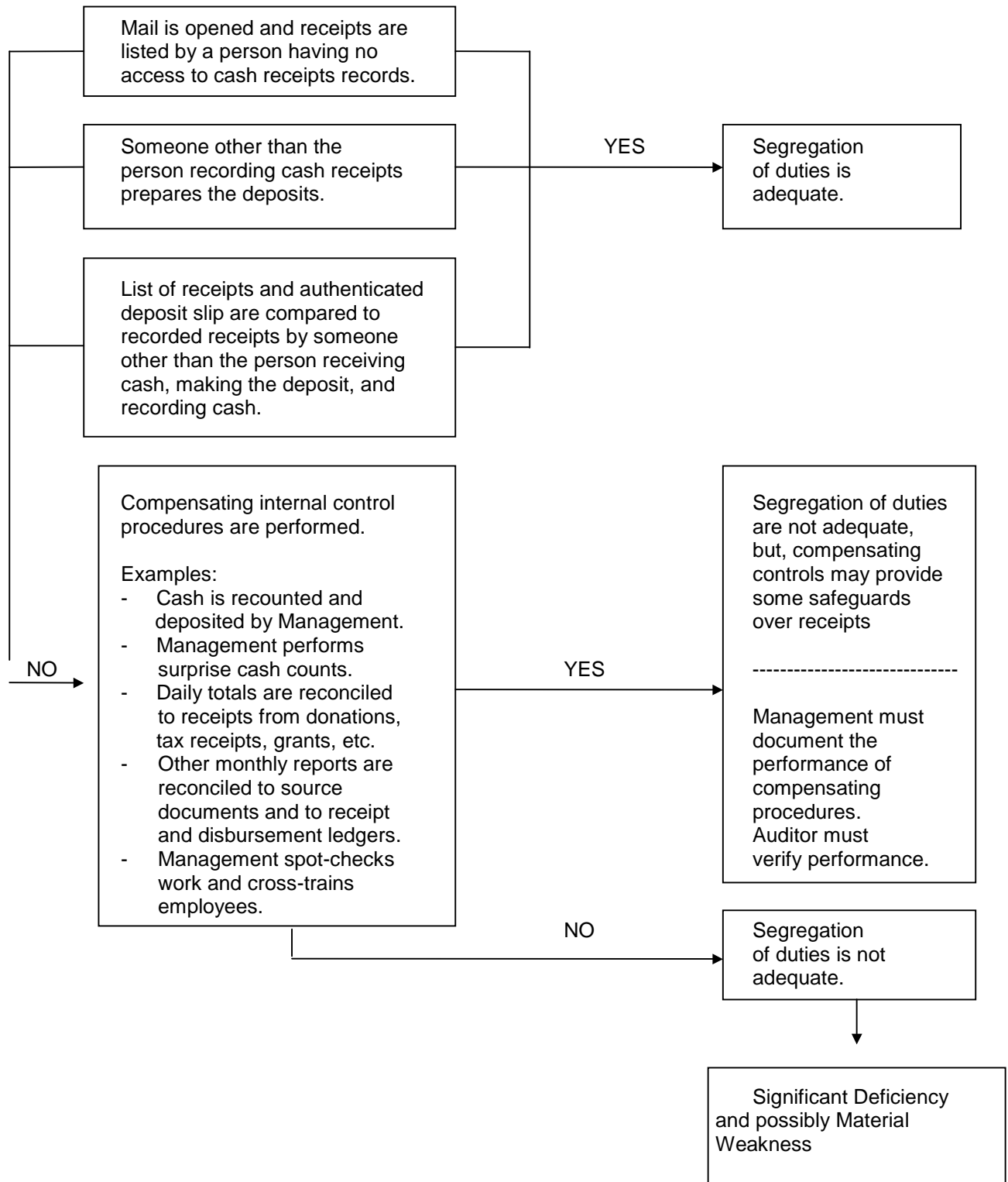
- Accounting policies and procedures manuals should outline specific authority and responsibility of individual employees, provide guidance for handling of specific transactions, communicate the design and objectives of the internal control structure.
- The manual should be complete, up-to-date, available for use by employees in the normal course of their work, and have the support of management.

Revenue

EXAMPLES OF INTERNAL CONTROL ACTIVITIES OR PROCEDURES

- Ensure staff is competent and is adequately trained.
- Management samples amounts and performs a recomputation.
- Policy and procedure manuals describe revenue collection requirements.
- Promptly investigate overdue receivables and take necessary action.
- Payors are instructed to write the name of the district clearly on the check and not to send cash.
- Incoming checks immediately receive a restrictive endorsement.
- The person receiving money should number remittances sequentially and prepare a list of all receipts. Cashiers should use a cash register, tape, or computer.
- The duties of handling and listing cash receipts, making deposits, maintaining the cash receipts journal, and posting to ledger accounts are performed by different individuals or have components reviewed by an independent party.
- Deposits should be reconciled to a list or a cash receipts tape prepared by a person who is independent of the receiving and recording functions.
- Bank accounts should be reconciled regularly and reviewed by someone who is independent of the cash collection and recording functions.
- Cash receipts and all related revenue accounts should be reconciled daily.

Compensating Controls Over Receipts



Payroll

EXAMPLES OF INTERNAL CONTROL ACTIVITIES OR PROCEDURES

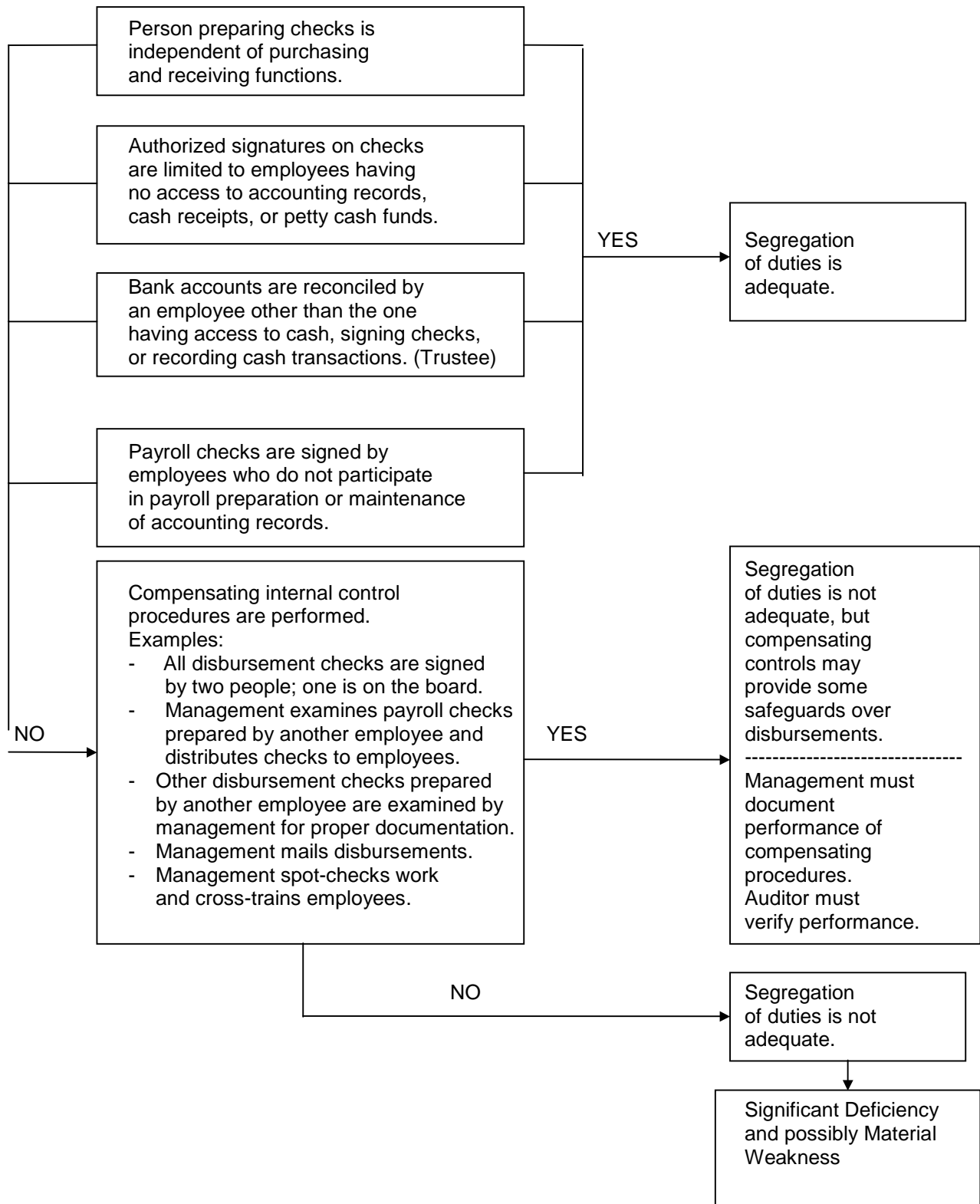
- Cumulative payroll disbursements should be periodically compared to amounts recorded in the budget appropriation.
- Management or another designated individual verifies the availability of positions before approving an appointment.
- Payroll computations for new employees and changes in deductions of existing employees are recomputed by a second employee.
- Attendance records or time cards should be approved by a designated person.
- Payroll checks are distributed by an employee who is independent of payroll preparation.
- The distributor of payroll checks is instructed to require identification from any employee not personally known to him or her, and is instructed to not give an employee's paycheck to someone else.
- The payroll revolving bank account is reconciled to the payroll expenditure account on the district's books.
- The monthly payroll is compared to the prior month and/or the prior year by fund and program.
- Management should review payroll allocated to specific programs.

Expenditures

EXAMPLES OF INTERNAL CONTROL ACTIVITIES OR PROCEDURES

- All requisitions must be approved by the board of trustees and availability of funds must be determined by the board treasurer or bookkeeper.
- Use pre-numbered documents (purchase orders, checks, etc.) and keep excess blank forms under the control of the board designated individual.
- Require competitive bids for larger purchases (> \$10,000.) **(KRS 424.260)**
- Periodically review stale purchase orders outstanding.
- The individual receiving goods or services must fill out a receiving report or sign a bill of lading.
- Compare invoice prices to order prices and check for mathematical accuracy.
- One invoice is stamped "original." Approval for payment can be made only from the original invoice.
- Cancel invoices by stamping them "PAID" once the check has been written.
- The bookkeeper and/or treasurer compare the order with the receiving report and the invoice before presenting the item to the board of trustees for payment.
- The cash disbursement journal is reconciled periodically to expenditure records
- The vendor file is periodically compared and reconciled to the file of unpaid invoices.
- Budgetary records are periodically reconciled by line items to expenditure records.
- Assign the duties of approving requisitions, preparing purchase orders, receiving goods or services, recording purchase orders, approving payment, preparing checks, signing checks, and preparing the bank reconciliation to different people.
- Bank reconciliations should be reviewed by someone (a trustee) who is independent of any other cash function.

Compensating Controls Over Disbursements



AICPA Statement on Auditing Standard No. 112 – *Communicating Internal Control Related Matters Identified in an Audit*

First, Who are the AICPA?

The American Institute of Certified Public Accountants is the national professional organization for Certified Public Accountants (CPAs) in the United States. The AICPA develops standards for audit and other services provided by CPAs. The Statements on Auditing Standards issued by the AICPA are one set of standards followed when audits of local governments are performed in Kentucky.

What is SAS 112?

A new auditing standard that requires auditors to:

1. evaluate identified control deficiencies and determine whether those deficiencies are significant and
2. communicate, in writing, significant deficiencies and material weaknesses to management and those charged with governance.

This SAS lowers the threshold of significance, therefore, more findings will be considered significant.

What is internal control?

A process designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- reliability of the financial statements
- effectiveness and efficiency of operations
- compliance with applicable laws and regulations

How will SAS 112 affect you?

1. More audit findings will be reportable, which means published rather than just discussed in the exit conference. We must report the potential for misstatement, not whether a misstatement actually occurred. It doesn't have to be material, just more than inconsequential.
2. The audit process will take longer because the auditor must gather more evidence and documentation to determine whether or not findings are significant. We are unsure what the additional costs may be. In some audits, it may be minimal, in other cases, it could be significant depending on the issues identified which require more fieldwork.

How is this different than current audit work?

- Communicating internal control related audit findings from the auditor to the auditee must be in writing
- Auditors have less ability to use discretion in determining what will be reported

What can you do to prepare?

- Identify weaknesses by reviewing prior year audits
- Identify key processes and controls in your office, the amount of existing documentation and training of your staff

- Determine steps that might be taken to improve the control environment in your office
- Ask yourself these questions:
 - What controls are in place over financial reporting?
 - Does supporting documentation exist to support financial activity?
 - Are duties adequately segregated?
 - Are IT controls over significant computer systems in place?
 - Are routine reconciliations performed? Is review and approval evident?
 - Are controls in place to adequately track and safeguard capital assets?
 - Does documentation exist to demonstrate internal controls were performed as planned?

Areas of concern that may be control deficiencies, significant deficiencies or material weaknesses:

- Employees or management who lack the qualifications and training to fulfill their assigned functions.
- Inadequate documentation of the components of internal control
- Inadequate design of internal controls over the preparation of financial statements or a significant account or process
- Inadequate segregation of duties within a significant account or process
- Employees lying to the auditor
- Management override of controls

Areas of concern that will be (at least) significant deficiencies:

- Ineffective antifraud programs and controls
- Ineffective controls over unusual and/or manual transactions
- Ineffective controls over period-end financial reporting processes

Areas of concern that will be strong indicators of a material weakness:

- Ineffective oversight of financial reporting and internal control by management
- The restatement of previously-issued financial statements to reflect the correction of a material misstatement due to error or fraud
- Material misstatement identified by the auditor that was not caught by internal controls
- Identification of fraud on the part of senior management
- Management's failure to assess the effect of previously reported significant deficiencies
- Ineffective control environment

What is the APA doing to prepare?

- Educating auditees about the new SAS
- Training our staff to identify and understand control weaknesses
- Working on a plan to ensure consistent application of SAS 112 across all audits
- Developing a list of most common exit conference comments that may rise to the level of "reportable" in future audits
- Attending GOLD Budget Workshops to provide information to local officials about this new SAS

Note: This new auditing standard applies whether an audit is performed by the APA or a private CPA firm.